

Ethiopia: Economic Performance and the Role of the Private Sector



Foreword

This study on Ethiopia is part of a series of annual country economic studies, undertaken by various Swedish universities and academic research institutes in collaboration with Sida. The main purpose of these studies is to enhance our knowledge and understanding of current economic development processes and challenges in Sweden's main partner countries for development co-operation. It is also hoped that they will have a broader academic interest and that the collaboration will serve to strengthen the Swedish academic resource base in the field of development economics.

This study was undertaken by Göte Hansson at the Department of Economics at the University of Lund.

A handwritten signature in black ink, appearing to read 'Per Ronnås', is positioned above the printed name and title.

Per Ronnås
Chief Economist

Preface

In addition to being a brief update of the Ethiopian macroeconomic situation, the current report focuses on the government's stated objective to increase the role of the private sector. The themes of the previous reports are given by their subtitles, which are presented below.

“Ethiopia, Macroeconomic Performance, Economic Policy and Swedish Aid”, *Macroeconomic Studies No 1/1989*, Stockholm: The Planning Secretariat, Sida

“Ethiopia 1990: A Change of Economic System? A Critical Assessment of the Economic Reform Programme of March 5th, 1990”, *Macroeconomic Studies, No 9/1990*, Stockholm: The Planning Secretariat, Sida

“Ethiopia – Away from Socialism”, *Macroeconomic Studies No 29/1992*, Stockholm: The Planning Secretariat, Sida

“Transition in Ethiopia 1991–1993”, *Macroeconomic Studies No 45/1993*, Stockholm: The Planning Secretariat, Sida

“Ethiopia 1994: Economic Achievements and Reform Problems”, *Macroeconomic Studies No 61/1995*, Stockholm: The Planning Secretariat, Sida

“Ethiopia 1995: Consolidation of Reforms – Implications for foreign aid”, *Macroeconomic Studies No 1995/64*, Stockholm: The Planning Secretariat, Sida

“Ethiopia 1996: Government Legitimacy, Aid and Sustainable Development”, *Macroeconomic Studies, No 1997/5*, Stockholm: Sida

“Ethiopia 1998: Regional and Business Sector Challenges”, *Country Economic Report 1998:3*, Stockholm: Sida

I am most grateful to a number of persons at various ministries, agencies, embassies, and private companies in Ethiopia who have provided information during my visits to Ethiopia. I would also like to thank the staff at the Ethiopian Embassy in Stockholm for their kind assistance in supplying information.

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Executive summary

The Ethiopian economy was severely hit by the drought in 2002/03 which led to a reduction of real GDP by 3.8 per cent. However, seen in a longer perspective, the economic performance in terms of fiscal balance and price stability has been satisfactory. The Ethiopian economy also suffers from the border conflict with Eritrea, which is still not solved even though there was a peace agreement in the year 2000. It still remains to implement the agreement and agree upon a border demarcation. This issue must be solved if conditions in the Horn of Africa are to have a chance to come close to the pre-1998 situation when the economic performance in Ethiopia and Eritrea was relatively good.

The Ethiopian economic transition towards a market economy with increasing private ownership has been one of the major objectives of the government since the beginning of the 1990s. The reform process has reached the level of implementation where, to a large degree, it has stopped. Several individuals outside the government have claimed that this stop of or slowed down progress is due to lack of government will; the government actions in terms of legislation and policy revision are said to be nothing but words to please the donors. Therefore, it is important that the government intensifies the activities in various fields, mainly in institution and competence building. This latter aspect cannot be overstated. Today private sector expansion is severely hampered by the lack of adequate competence in important fields like accounting, auditing, business- and project evaluation, and commercial law. This is particularly important for small and medium-sized enterprises that want to borrow money for their investments and where the banks of today have problems making proper credit evaluations. Finally, the legal institutions for handling commercial relations and disputes must be updated, or even created, to reduce the uncertainties for businessmen in their decision-making and business operations. It is also crucial that the trust between the Ethiopian government and the private sector as well as between the domestic and foreign financial institutions is improved, so that the resources that can be made available can be efficiently recruited and used for the urgently needed private sector expansion and thereby for growth and development.

1 Introduction

Ethiopia is widely associated with poverty and famine. Yet with the replacement of President Mengistu Haile Mariam in May 1991 and the end of the Ethiopian civil war, much hope rests on reforms that can lead to changes in the common picture of Ethiopia as a country with what seems to be everlastingly severe problems. In 1991/92 the Transitional Government presented quite ambitious plans for economic and political systemic changes (TGE 1991 and Hansson 1995: Chapter 7). It also presented changes in the administrative structures of the country.

A new era in the history of Ethiopia began with the declared objectives to transform the dictatorial one-party state of Ethiopia, with its frequent violations of human rights and its socialist command economy, into a multi-party democratic society, where human rights are respected and where private entrepreneurs and the operation of market forces are encouraged (Hansson 1995: 145, 1998 and 2001). Furthermore, it was declared that Eritrea would become independent after an Eritrean referendum that eventually led to formal independence in 1993.

Today agriculture is the sector that clearly dominates the economic activities. As it is highly weather-dependent, fluctuations due to poor weather conditions create drastic economic vulnerability but also severe problems for Ethiopia in feeding its population. Therefore the diversification of the economy is urgently needed and such diversification must largely come from private sector growth. However, at present the environment for this sector is not ready to bring about such a far-reaching transformation of business life.

The present study focuses on the economic systemic transition, in particular the increased role of the private sector in diversifying the Ethiopian economy and making the economy less dependent on the agricultural sector.

This study analyses the problems and potentials for such a private-sector based diversification in the case of Ethiopia. The major focus will be on the post 1995 challenges and actual changes. (For an analysis of the changes prior to 1995, see Hansson 1995).

The study begins with a brief analysis of the Ethiopian macro-economic performance. Following this, the institutional preconditions for a successful transformation of the Ethiopian business life will be examined. Here the focus will fall primarily on the legislative matters and the structure of and policies related to the financial sector. Finally, the major findings will be summarised.

2 Macroeconomic performance

During the past five years, the Ethiopian economy has suffered from a severe drought and a serious border conflict with Eritrea 1998 – 2000. It should be noted that in July 2004, the process of border demarcation is still ongoing and is characterised by the conflicting interests of the two countries. This situation has had a negative impact on the possibilities for a development that can alleviate the poverty in Ethiopia.

Ethiopia enjoyed a positive development of real GDP during the post-Mengistu period up to the outbreak of the border conflict with Eritrea. On average the economy grew by around 5 per cent during the decade through 2001/02 (see IMF July 22, 2003: 13). The agricultural sector grew by 8 per cent, while the industrial sector and the service sector (including public administration) grew by 7 and 9 per cent respectively during the same period. The growth of the public sector was partly due to the border conflict with Eritrea (*ibid.*).

Due to the drought that hit Ethiopian agriculture in 2002/03 the real GDP growth fell from 7.7 per cent in 2000/01 to estimated 1.2 per cent in 2001/02 and an estimated negative growth by 3.8 per cent in 2002/03. The value added in agriculture fell by 12 per cent (MOFED 2003: 4).

The current account balance has also been negatively affected by the poor economic performance during recent years. As a percentage of GDP the current account deficit has increased from 9.7 per cent in 2000/01 to an estimated 12.8 per cent in 2002/03 (excluding official transfers)(IMF 2003: 41). If official transfers are included the deficits are reduced to 3.6 and 5.7 per cent of GDP for 2000/01 and 2002/03 respectively. The negative development in the current account is also due to a fall in the terms of trade owing to higher oil prices and lower coffee prices in the export market. In fact, the export earnings from coffee exports measured in USD fell by close to 55 per cent between the fiscal years 1998 and 2001. Taking increased official transfers into consideration, the Ethiopian gross official reserves amounted to 4.3 months import overage in 2002/03.

In relation to Government operations, the fiscal balance excluding grants changed from -9.6 per cent of GDP in 2000/01 to an estimated -15.8 per cent in 2002/03. The corresponding figures including grants are -4.8 and -8.0 per cent respectively. To a large extent the increase in expenditures is poverty-targeted expenditure that increased from 9 to 14

per cent between 1999/2000 and 2002/03 (MOFED 2003: 4). Furthermore, it is interesting to note that defence spending in real terms has decreased from over 13 percent of GDP in 1999/2000 down to 5.3 per cent in 2002/03 even though the border conflict with Eritrea, in terms of border demarcation, is still unsolved (July 2004).

The Ethiopian government has continued its policy of keeping the money supply tight. Thus, the fiscal deficit has not been financed by an uncontrolled expansion of money supply; broad money has grown by some 10 to 12 per cent annually during the period 2000/01–2002/03 (IMF 2003: 40, IMF 2004: 25).

The negative development in agricultural production has contributed to a 15 per cent increase in the consumer price index during 2002/03 (MOFED 2003: 4). This was a clear break from the previous two years characterised by falling consumer prices. However, the “average core inflation” was still quite low, below 1 per cent.

To summarise, looking aside the border conflict with Eritrea (for which the government cannot be completely free from responsibility) and the drought-related problems, which are largely due to the weather and governance deficiencies, e.g. in the agricultural land-tenure system, the macroeconomic development during the past years can be characterised as relatively satisfactory. This is particularly so with the monetary policy.

Finally, the future macroeconomic development will most likely be affected by the ongoing problems that Ethiopia and Eritrea have to solve in relation to the implementation of the demarcation of the border that came about after the peace agreement following the conflict that arose in 1998. Another interesting note can be made regarding the evaluation and assessment of country policy and performance that are included in IDA's Performance-Based Allocation System (see IDA 2001 and Kaufmann et al., June 30, 2003). We will come back to the conclusions of these studies below.

Table 1: Selected economic indicators for Ethiopia

	2000/01	2001/02	2002/03	2003/04	2004/05	2005/06
			rev.est.	rev.prog.	rev.proj.	rev.proj.
<i>Annual percentage changes</i>						
GDP (constant factor costs)	7.7	1.2	-3.8	6.7	6.4	6.1
Inflation (CPI, period average)	-5.2	-7.2	15.1	5.5	3.0	3.0
Nominal effective exchange rate	6.5	-7.8	-12.5	...	...	...
Real effective exchange rate	-12.0	-3.3	5.9	...	...	...
<i>Government budget (% of GDP)</i>						
Defence spending	6.1	5.0	5.3	3.7	3.4	3.1

Deficit (on a cash basis)						
Incl. grants	-4.8	-7.4	-8.0	-6.2	-4.6	-3.6
Excl. grants	-9.6	-12.1	-15.8	-13.3	-10.6	-8.8
External financing (net)	3.8	9.5	6.8	5.1	5.1	3.3
External grants	4.8	4.7	8.0	7.1	6.0	5.2
Privatisation receipts	0.7	0.1	0.0	0.1	0.2	0.1
<i>External affairs (annual % change)</i>						
Exports, f.o.b.	-4.8	-2.2	6.7	7.3	11.5	9.5
Imports	-3.4	8.9	14.4	9.3	1.8	1.3
Current account (incl.official transf.)	-4.0	-5.7	-4.7	-7.9	-7.4	-6.2
Current account (excl.official transf.)	-10.1	-12.9	-12.8	-14.0	-12.4	-10.6
Terms of trade (annual change)	-3.6	-11.1	-9.4	-2.6	4.2	1.6
Nominal effective exchange rate	6.5	-7.8	-12.5	...	...	...
Real effective exchange rate	-12.0	-3.3	5.9	...	...	...
External debt (incl.out- standing fund credit, per cent of GDP)	86.3	109.8	98.7	94.3	92.5	89.5
Debt service ratio (per cent of exports of goods and non- factor services) before debt relief on an accrual basis	22.7	17.0	14.9	18.5	16.8	16.0
Gross official reserves (in months of imports)	2.0	3.3	4.3	4.6	4.8	4.8
<i>Money, prices and investments</i>						
Broad money (increases in % of beginning-period stock of broad money)	9.5	12.3	10.4	13.4	10.7	9.2
Inflation (CPI, period average)	-5.2	-7.2	15.1	5.5	3.0	3.0
Gross domestic Investments (% of GDP)	17.8	20.5	21.2	23.3	23.1	22.9
Private investments	9.3	9.0	10.7	11.4	11.5	11.9

Source: IMF (2004), (2003): Tables 3, 5, 6, 7.

3 An increased role for the private sector

Ever since March 1990, and even more so since the launching of the transitional economic policy in November 1991 (TGE 1991), the government of Ethiopia have declared that the private sector must be given a more central role, both in non-subsistence agriculture and in non-agricultural sectors.

In the recent *Sustainable Development and Poverty Reduction Program* the following points are highlighted:

- Concentration on agriculture, which is the source of livelihood for 85 % of the population and the bulk of the poor. Agriculture is a potential source of surplus to fuel the growth of other sectors of the economy;
 - Strengthening private sector growth especially in the industry, to promote off-farm employment and output growth, supported by public investments in necessary infrastructure;
 - Rapid export growth, including high value agricultural products and export oriented manufacturing sectors (particularly intensified processing of high quality skins/leather and textile garments);
 - Investment in education and enhanced efforts to build capacity to overcome critical constraints for the implementation of development programs;
 - Deepening decentralization to shift decision-making closer to the grass roots, to improve accountability, responsiveness and service delivery;
 - Improvements in governance to empower the poor and to establish an appropriate framework for private sector growth and development;
 - A strong focus on agricultural research, and water harvesting, small scale irrigation; and
 - Increased water resource utilization to ensure food security;
- (SDPRP, December 2003:1, see also SDPRP, July 2002, for the original points in the program)

From this list it is clear that the agricultural sector is still given high priority in the formation of policy. This is natural, given the present

population pressure and the regular droughts that hit Ethiopia. However, increased emphasis must be placed on the non-peasant sectors if Ethiopia is to modernize and achieve a sustainable, and non-weather-dependent path of economic development.

In the list above, the emphasis on the role of the private sector is repeated, as it has been ever since the presentation of the reforms in post-Mengistu Ethiopia in the late 1980s and thereafter in March 1990.

Reform processes can be divided into the following four stages:

- Defining the objectives of the reform
- Designing and making decisions on policy actions and measures
- Implementation of the “new” policy
- Evaluation and revision of the “new” policy

In Ethiopia the first two stages have been largely completed. The first stage was taken already during the first years of the 1990s with the publication of the transitional economic policy paper (TPE 1991). The quite demanding task of stage two, i.e. designing and taking decisions on policy measures, has also been relatively successful and consistent with the overall long-term aims of the reform policy (see e.g. Hansson 1995 and 2001). However, the third and fourth stages are still in their infancy. As will be emphasised below, it is important that this process get on track to ensure that the declared intentions of the government should not be questioned by reference to the argument that the reforms are just paper reforms to please the donor community.

To carry through far-reaching economic reforms of the kind that is needed and also decided upon in the case of Ethiopia, it is important to have good governance among the various ministries and agencies. Therefore, it is of interest to comment on some important principles for good economic-policy management (see e.g. Harberger 1984 and Fischer 1987).

‘Avoid poor technicians in policy-making’. To satisfy this principle is far from easy in a country like Ethiopia, with its long history of a non-market economic system where many civil servants for policy design have been recruited on political grounds rather than on the basis of professional qualifications. Furthermore, the Ethiopian educational system has so far not managed to produce the much-needed staff for efficient policy-making. Therefore, even though the government has increased its efforts in the educational sector, Ethiopia has difficulties living up to this principle. However, even though the system transition of the country is highly needed, it is important to keep the speed of the changes and the delegation of functions out from the central government at a level that is not beyond the qualifications of the staff of various institutions, local governments, public enterprises, and private enterprises. Thus, twelve years after the reforms were initiated, there is still more to be done in terms of educating and recruiting qualified civil servants, instead of poor technicians in policy making.

Another principle of good management is to *‘keep budgets under adequate control’*. As can be seen from *Table 1*, this principle has largely been satisfied. The same seems to be the case with the principle to *‘keep inflationary pressure*

under reasonable control’, even though the heavy fluctuations in food supply, due to weather conditions, have created some problems in this regard.

In relation to the transformation of the business life away from state-ownership to private ownership, much remains to be done. Here it is important to pay due respect to the above-mentioned principle *’to take a technical rather than ideological view of the problems associated with public sector enterprises’* and to *’make the borderlines between public and private sector activity clear and well defined’*.

There are three important conditions that must be improved in the Ethiopian economic system to make possible a more central role for the private sector.

Firstly, it is important that the financial system becomes appropriate in relation to the new role of the private sector that the government has declared. Both in terms of availability of financial resources, credits and in terms of efficient banking, quite far-reaching reforms of the financial sector must be introduced and efficiently implemented. In particular this is important for new and small enterprises.

Secondly, reforms of the legal institutions like competition legislation and the legislation related to collaterals must be introduced and implemented if the reforms are not to remain words but are also to become reforms put into action.

Thirdly, the business climate must be improved in terms of stability, good governance by the government and with institutions that are able to facilitate private sector development.

Hansson (1995) concluded that after the defeat of the Mengistu government in May 1991, a number of important reforms have been introduced. The purpose of these reforms is to make the economy more market-oriented and to increase the role of the private sector as owner of productive resources. Up to the second half of the 1990s the new policy also led to increased economic growth, albeit from very low levels, until the collapse of the Ethiopian-Eritrean relations in 1998, when the border conflict led to a new war. However, it was also concluded that in 1994/1995 there still remained important fields where more reforms were to be introduced and implemented, if the transformation of the economy towards a more market-oriented system was to be realised. The fields mentioned as were for example the exchange rate policy, the trade policy, the financial sector and the issue of ownership of land and other productive resources (Hansson 1995: 159f). Furthermore, it was emphasised that in the new market-oriented Ethiopian economic system it is important to keep to the new strategy about the role of the State in business life (Hansson 1995: 161).

Privatisation plays an important role in the World Bank’s list of second-generation reforms (World Bank 1997). Thus, the Ethiopian government’s emphasis on the role of the private sector is easy to understand and among members in the Ethiopian business community the steps taken so far are seen as clearly positive, even though much more is both wanted and needed in the “new” Ethiopian economy.

During interviews conducted by the author of this study before 1997, the following problems were identified:

- Financial sector policies
- Problems related to the issue of collaterals
- The land-lease system
- Bureaucracy
- Fear of discriminatory practices in favour of party-owned enterprises
- Lack of updated commercial law including anti-trust legislation
- Lack of dialogue with the government
- The investment code for foreign investors

Even though reforms have been introduced during the past decade, interviews and on-site studies by the author in October 2003 and March 2004 revealed that some of the listed problems continue to work as serious barriers to private-sector expansion.

This is the case with:

- Financial-sector policies and their functioning, where foreign partners and companies are still not allowed to establish a business within the banking sector;
- Problems related to the issue of collaterals, in particular a problem for small and medium sized companies;
- Access to affordable land for business investments even though the government (MOTI) has launched an Industrial Zone Project to reduce this problem (SDPRP, December 2003, 88);
- Bureaucracy. Even though bureaucracy has been reduced, more remain to be done in terms of making institutions more competent and able to cope with the efficient implementation of the new policy measures, e.g. the new tax policies like the new VAT regulations;
- The worry that party-owned companies are favoured by the government and relevant authorities. Regarding this issue, Prime Minister Meles Zenawi has invited critics to report their complaints and evidence in order for the government to take appropriate actions. However, so far (March 2004) and to my knowledge, this has just started to be implemented and there seem not to have been any cases where adjustments have been made by the government;
- Commercial law. A revised commercial law has been introduced but it is too early to make a proper evaluation of its functioning. This is particularly the case with the new competition legislation that will be analysed below;
- The dialogue between the government and the private sector. In 2002 the government established the Public-Private Consultative Forum, which is chaired jointly by the Minister of Trade and Industry and the President of the Ethiopian Chamber of Commerce. This national forum will, according to the government, be supported by sector sub-committees for those industries that have been identified as priority industries in the Industrial Development Strategy. In Decem-

ber 2003 such sub-committees were established for leather and leather products, textiles, and horticulture. (SDPRP, December 2003: 88). So far (March 2004) this Forum has met four times (it should meet quarterly);

- The investment code for foreign investors. This code has been simplified through the introduction of a one-stop-shop procedure;

4 The business climate in Ethiopia

Kaufmann et al. (2003) have analysed the business environment in Ethiopia in 2002. Among their conclusions we note that the business climate in Ethiopia is inferior to the corresponding situation in sub-Saharan Africa in relation to “Voice and Accountability”, “Political Stability”, “Government Effectiveness” and “Regulatory Quality”, whereas the Ethiopian situation regarding “Rule of Law” and “Control of Corruption” seems to be better in Ethiopia in comparison with the sub-Saharan average.

Furthermore, the *Private Sector Advisory Service of the World Bank* analysed the Ethiopian “Entry Regulation Cost” and found that these costs are relatively low and below US\$ 500, which, for example, is about half the equivalent costs in Mexico, Poland and Malaysia and just around one sixth of the costs in Hungary (World Bank 2003b).

In another World Bank study, *Country Policy and Institutional Assessment - Africa Region* (CPIA), Ethiopia is classified as “Moderately Unsatisfactory” in 2003. This rating is due to a very low rate for “Structural Policies” which is categorized as “Unsatisfactory for an extended period”. From the point of view of governance and foreign-aid preparedness this is negative in an aid-competitive situation.

Table 2: 2003 Country Policy and Institutional Assessment – Africa Region

Ethiopia				
Economic	Structural	Social	Public Sector	Overall
Management	Policies	Inclusion	Management	rating
Average	Average	Average	Average	Average
3	1	4	4	3

Explanation: 1. Unsatisfactory for an extended period, 2. Unsatisfactory, 3. Moderately Unsatisfactory, 4. Moderately Satisfactory, 5. Good, 6. Good for an extended period

Source: World Bank (2003a)

To this should be added the uncertainty that the unsolved border conflict with Eritrea has created.

Structure of and constraints for the Ethiopian private business sector

The non-government business sector outside agriculture in Ethiopia is characterised by a large number of small companies. This was also the case under the former Mengistu-government, where in 1990 no less than 50 per cent of the total number of manufacturing industries were privately owned but where the private companies just employed some seven per cent of the total number of manufacturing employees (*Census of Manufacturing Industries in Ethiopia, 1990*). Since then important changes in the economic system have been introduced and the role of the private sector in the economy has been strongly emphasised in various policy documents. Even so, the private sector is still composed of micro- and small enterprises (MSEs), whereas, as a rule, the large industrial enterprises continue to be state-owned.

According to a survey by the Central Statistical Authority, out of 588,286 industrial establishments in 1995/96 there were 584,913 micro- and 2,731 small-scale establishments. The number of employed in these micro- and small-scale enterprises was 886,299 persons, or 89.75 per cent of total industrial employees (EDRI 2004: 3).

In 2003 EDRI also conducted a survey about micro- and small enterprises (EDRI 2004). It is estimated that the number of self-employed private entrepreneurs in 1999 amounted to 1,216 million (information from EDRI). These firms can, according to the same source, be classified mainly as micro-enterprises. A survey made by ECA (2001) indicated that the business environment or business climate in sub-Saharan Africa is a severe obstacle for the expansion of these enterprises. That study also concluded that the infrastructure in Ethiopia was particularly disabling (quoted from EDRI 2004: 4).

The EDRI survey was carried out in May-June 2003 and covered six major cities in Ethiopia. In total, a random selection of 1000 enterprises was included in the survey (see EDRI 2003: 1f). The response was quite positive and 974 (of which 551 micro- and 226 small) enterprises responded. An important set of questions in the EDRI-survey concerned how the Ethiopian MSEs have been affected by the changes in the policy environment.

According to EDRI (2004):

- More than 95 per cent of the surveyed MSEs answered that they do not feel that they have received any support “whatsoever” (EDRI 2004: 8).
- Of the MSEs that existed in 1985 EC (i.e. 1992/93) 53 per cent have not felt any changes in the business environment (ibid. Table 3.1).
- As regards licensing procedures, no less than 68 per cent of all MSEs in the survey have found improvements in these procedures (ibid. Table 3.2).
- 76 per cent of the MSE have increased their investments since the introduction of the reforms in Ethiopia (ibid.).
- 25 per cent of the micro- and 32 per cent of the small enterprises in the survey have felt increased support from the government whereas 20 per cent in each group have experienced a reduction in government support (ibid.).

- 93 per cent of the MSEs are single-owned (91 per cent of small and 96 per cent of micro-enterprises).
- Male-owned MSEs dominate and amount to 74 per cent of the MSEs whereas just 23 per cent were female-owned.
- Capital constraints rank highest among the various barriers to entry or establishment of a new firm. No less than 82.1 per cent of the MSEs ranked this constraint among the major three constraints to their expansion and growth.

Another study “*Determinants of Private Sector Growth in Ethiopia’s Urban Industry: The Role of Investment Climate*” by DECR/RPED from the World Bank, in collaboration with EDRI, identified a number of constraints that negatively affect business activities in Ethiopia. The results of this World Bank/EDRI study

“suggest that controlling for size and type of industry of employment, a typical worker in Ethiopia is 80 percent less productive than the average worker in Bangladesh and more than two times less productive than the average Chinese worker. *The bulk of the total factor productivity (TFT) shortfall (about 77 percent) can be accounted for by the overall business productivity (that is, the investment climate) and only 23 percent can be explained by the fact that Ethiopian factory workers are less equipped and less educated.*”
(my italics) (DECR/RPED 2002: vi)

The same study notes the following major problems, specific for the Ethiopian private sector business activities:

- Tax rates and tax administration
- Access to land
- Reliability of infrastructure (mainly power, telecommunication)
- Credit procedures and perceived corruption in the banking sector
- Collateral requirements
- Unequal and more favourable treatment of State-Owned Enterprises

Furthermore, the low per capita income in Ethiopia limits the possibilities to expand industrial production to the domestic market. Because there is a lack of experience in industrial export production, the limited size of the current domestic market constitutes a serious problem for private sector expansion.

In relation to the development of the relative size of the private manufacturing sector it can be noted that in the year 2000 the private sector continued to be dominated by micro- and small enterprises. This is reflected by the fact that the private sector’s share in total manufacturing value added amounted to 23.3 per cent while the corresponding share of employment was 41.7 per cent. The largest sub-sectors of the private manufacturing sector in Ethiopia are encountered in Machinery and Equipments.

The process of privatisation was launched in 1994 by the establishment of the Ethiopian Privatisation Agency (EPA). The process has

started, though it has been concentrated to small trading enterprises and so far only a small number of larger manufacturing enterprises have been privatised. By June 2003 around 230 units have been privatised and 256 other units have been listed for sale and preparation for privatisation (MOFED 2003:89).

There are several reasons behind the relatively slow process of privatisation in Ethiopia. In addition to the above list of general problems facing the private sector there are a relatively large number of alternative modes of privatisation that are theoretically available: public offering of shares, private sales of shares, offering private businessmen to invest in state-owned enterprises, sale of state-owned enterprise assets, re-organisation (or break-up) of state-owned enterprises into component parts, management/employee buy-outs, lease and management contracts. As analysed by Vuylsteke 1988, and for the case of Ethiopia briefly analysed by Hansson (1995: 124ff). Each of these alternatives have their own problems of implementation that must be taken into consideration if privatisation is to be successful or even possible to realise.

One set of issues that is central in the process of privatisation is the problem of valuation of enterprises that for many years have operated in a highly centralised, planned and non-competitive economy. In the old Ethiopian economic system prices were controlled and administratively determined, the exchange rate was heavily overvalued and there was far-reaching protection against foreign competition. All these factors contribute to difficulties in making a correct evaluation of the enterprises in the new, more market-oriented economy, where prices and trade policies have been largely liberalised and where the exchange rate of the Ethiopian Birr has come closer to its market value.

To find a reasonable value for an enterprise that is to be sold is crucial both for the seller, in this case the Ethiopian government, and the potential buyers. Of course, one can let the price be determined through an auction but even in this case the actors need some sort of information about the financial conditions of the enterprise in question.

In a study from 1994 about the problems and prospects of private sector development it is shown that the problems of evaluating the public enterprises were quite large (Kuma Tirfe 1994: 70ff). According to Kuma Tirfe (1994: 75) in 1993 there was a severe lack of up-to-date information about the financial status of the Ethiopian public enterprises. Another problem was that around 25 per cent of the public enterprises had a negative net worth (Kuma Tirfe 1994: 71). Of these enterprises 42 per cent were industrial enterprises, agricultural enterprises comprised 28 per cent, 16 per cent were found in construction and the rest of the state-owned enterprises with a negative net worth operating in the housing, hotel, mining and transport sectors (ibid.: 76). Furthermore, it was noted that the group of public enterprises with a large positive net capital worth was dominated by core industries which are not included in the privatisation programme.

Kuma Tirfe (1994: 77) also made another interesting observation about the public enterprises in Ethiopia. If, as a sort of risk premium, one Birr of credit should be secured by assets of a value of at least 2 Birr, only 13 per cent of the public enterprises in Ethiopia at the time of writing the article (1993) satisfied that criterion. In all other cases, i.e. for

87 per cent of the enterprises, the equity-debt ratio was below 2. This means that these enterprises can be expected to be of little interest for private investors.

One important pre-condition for business evaluation is that there exists a generally accepted accounting standard that is efficiently implemented and that there are certified auditing agencies or companies in place when a business acquisition is considered, this is true both in the case of privatisation of state-owned enterprises and acquisitions of private enterprises.

Given this background, it is of interest to analyse the accounting and auditing resources in Ethiopia. The international company “Ernst and Young” has recently performed an investigation of the accounting and auditing situation in the private sector in Ethiopia (CFAA-Study Ethiopia May 2003 by Ernst and Young).

That study found among other things that:

- There are no national accounting standards in Ethiopia
- The accounting system and the quality of accounts differ due to the absence of national standards and entities’ background
- The Commercial Code gives limited guidance on disclosure requirements.
- No national auditing standards exist
- A strong accounting or auditing professional body is needed but does not exist
- The internal audit function is at a very rudimentary stage and needs to be developed
- Financial management is neglected

(Ernst &Young 2003: 12f)

On the basis of the findings a set of recommendations is presented of which the following should be given special attention (ibid p 13f):

- Ethiopia needs national accounting- and auditing standards to bring about a greater understanding of financial statements and bring the quality of audit work closer to the internationally accepted standards.
- As the accounting and auditing profession needs to be better governed and monitored, the Government should consider taking the initiative and set up an ad-hoc committee consisting of the Office of the Auditor General, a high qualified lawyer, professional accountants and the academia. This committee should be tasked to recommend a legal and institutional framework. As a minimum, the output of the committee’s work should bring about an accounting law and an auditing law, as well as the following:
- A national accounting and auditing standard-setting body should be set up and ought to be composed of the Office of the Federal Auditor General, Ministry of Revenue, professional accountants, auditors associations, academia and the industry.
- A national accounting and auditing monitoring body should be set up and ought to be composed of the Office of the Federal Auditor

General, professional accountants and auditors associations, a reputable lawyer and others with knowledge and experience in accounting and auditing. ...

- Strengthening EPAA [Ethiopian Professional Association of Accountants and Auditors.] ...
- Strengthening IIA [Institute of Internal Auditors]. ...

It should be noted that the concept of internal auditing is something that does not exist in the current legislation, where external auditing is prescribed for enterprises that satisfy some requirements related to, for instance, the company size and ownership structure (Ernst &Young May 2003: 19).

To this list we would like to add and emphasise the need for a far-reaching revision of the curriculum of the law and business faculties at the University of Addis Ababa. At present there seems to be much work to be completed in adjusting the curriculum in these faculties to the new more market-oriented economic system. In addition, the judicial system must be upgraded, so that there are special commercial courts that can handle problems and even conflicts that tend to arise in commercial relations. As long as there does not exist an appropriate judicial system including proper and legitimate institutions, this will constitute a severe problem for expanding businesses. Interviews in Addis Ababa in early 2004 revealed that the “Arbitration Institute” within the Addis Ababa Chamber of Commerce handles commercial disputes that arise.

From what has been concluded above, in order to stimulate and facilitate increased private sector activities through privatisations, acquisitions and new investments, following the above recommendations is of the utmost importance in reducing risks and simplifying access to reliable business/information needed for a potential investor to make the right decision.

5 Financial sector problems

One crucial problem in the process of privatisation and modernisation in Ethiopia is that the financial sector is seriously underdeveloped. Thus, in general, access to credit for business activities is low. This was identified as one of the major, and in fact *the* single most severe constraint for the expansion of Micro- and Small Enterprises (MSEs), as was noted above from the ERDI-survey of Ethiopian MSEs. It is also one of the major problems in rural areas, where credit frequently has to be obtained through various informal credit systems. In the informal credit market, as a rule, the rates of interest are far above the levels that are offered for loans in urban areas. This is a severe obstacle to the development of the rural economy.

During recent years the private sector has been allowed to establish banks. At present (March 2004) there are six private and three government banks operating in Ethiopia, one which is owned by the party-affiliated EFFORT-conglomerate (see below) and another which is owned by the other large business conglomerate, the MIDROC-Ethiopia group (see below).

A problem that used to exist in the Ethiopian financial sector was the narrow interest rate spread between lending and borrowing rates. Today there is a new situation where there is a legislated floor on the rate of interest for deposits, 3 per cent, whereas the lending rate is up to the individual banks. However, the Government banks have a leading role in this process through their government ownership that can also be used as a regulator of the activities in the private sector.

The private banks frequently complained of the low interest rate margins that used to exist, arguing that low interest rate margins risk reducing the provision of credits to projects that are risky from the perspective of the banks. In a more liberalized financial market such projects would have a chance to obtain credit at higher rates of interest. Today, this criticism is not relevant as there is no upper limit on the lending rates. However, the current legislation, for example in terms of the prohibition of, and thereby also the absence of foreign banking institutions in Ethiopia, is still a severe restriction on the financial sector's possibility to serve the private sector in financing risky projects.

During the rule of Mengistu Haile Mariam the private sector's share of the loans and advances were in the range of 20–30 per cent, with the exception of 1990/91 when the private sector's share was around 40 per cent (Itana Ayana 1994: 241).

One result of the economic reforms that have been introduced is that, from 1994 private sector credit has dominated the credit growth in Ethiopia. During 1994/95, 1995/96 and 1996/97 the private sector credit growth as a share of total credit growth was 134, 211, and 119 per cent respectively (World Bank 1997a: Annex A6).

In the fiscal year 2002/2003, the loans to the non-government sector amounted to 87 per cent of the total loans disbursed (SDPRP, December 2003:12). Furthermore, it is noteworthy that the market share of the private banks has been steadily growing since 2000 (*ibid.*). With regard to the development of the private banks' share of new loans this has increased from 36.6 per cent in the fiscal year 2000/2001 up to 44.1 and 57 per cent in 2001/02 and 2002/03, respectively (*ibid.*).

One growing problem for the government-owned commercial-oriented banks in Ethiopia is the increasing numbers of “non-performing loans” (NPL), that is debts that are not repaid in accordance with the lending contract (see Addis Tribune, February 6 1998, reprinted in Press Digest 12 February 1998: 16f). In the relatively far-reaching Commercial Bank Restructuring Plan (Commercial Bank of Ethiopia 2003: 3), it is stated that the “magnitude of NPLs stood at 61.8 % of the total outstanding loans as at the end of June 2002”. The restructuring of the Commercial Bank aims to reduce the NPLs to 20 per cent, and the National Bank of Ethiopia has issued new directives for revision and supervision of banking services (Directive No. SBB/32/2002).

The current problems with NPLs have their origins in a number of reasons, such as corruption, lack of competence in the banks, and lack of legal institutions in cases of failure to fulfil obligations to the banks. Quite a number of these problems relates to the lack of, or absence of proper accounting and auditing procedures and competence in Ethiopia, e.g. for supervision of the banks. The restructuring plan notes this and states that there must be improvements of bank management and control mechanisms. This in turn requires ambitious education and competence-building within the banking sector.

In relation to the problems for private sector expansion that can be linked to the possibilities to obtain credits, it should be noted that foreign banks are not allowed to operate in Ethiopia. The official motivation, frequently mentioned in the interviews that the author of this study conducted in October 2003 and March 2004, is that there is a lack of supervisory capacity in the National Bank of Ethiopia. This motive can be questioned but it reflects lack of trust between the National Bank and potential foreign banks.

For the Ethiopian enterprises there is another restriction in the financial sector that is even harder to understand. Ethiopia is a member of the African Development Bank (ADB). One of the objectives of this bank is:

To support various types of productive enterprises including investments in key service industries, which generate value-added and foreign exchange. This will be achieved by providing assistance in the form of loans as well as equity and by ensuring that these enterprises are managed with the discipline which is necessary in order to enable them to achieve the objectives for which they were established.

(ADB, Policies and procedures: Industrial Sector Policy Paper)

However, Ethiopia has prohibited the ADB from giving loans to private companies. In the domestic market as well as in the export market the Ethiopian enterprises face competition from other enterprises that have been granted the favourable ADB loans. Thus, the rules in Ethiopia clearly discriminate against the Ethiopian enterprises. There are various ways to eliminate the cost disadvantage of Ethiopian firms, import duties, government subsidies to domestic firms and/or export subsidies. Nevertheless, these alternatives are clearly inferior to the more obvious and less costly alternative, that is, to allow ADB to work in Ethiopia in the same way as it does in other countries.

6 Ownership concentration

The increased role of the private sector in the Ethiopian economy outside the agriculture sector is largely due to two groups of actors, the MIDROC-group, owned by the Ethio-Saudi businessman Sheik Mohammad Hussein Al-Amoudi, and the TPLF-owned *Endowment Fund for the Rehabilitation of Tigray*, the EFFORT-group.

Sheik Al-Amoudi's business activities include agricultural, industrial and service activities. MIDROC-Ethiopia includes for example the newly completed luxury Sheraton Hotel in Addis Ababa, the Pepsi-Cola factory in Addis Ababa, the National Mining Corporation, Dashen Bank, and Nyala Insurance Company but also companies in agriculture, transport, and the construction sectors. According to informal information, MIDROC-Ethiopia also has, or has advanced, plans to go into the health and education sector, including the establishment of a private university.

It is obvious that the MIDROC-group has a size and orientation that makes it highly influential and important in the Ethiopian business life. Its activities also seem to be of a long-term character. It is of great importance that the MIDROC-group does not get a dominant position within a specific sector or market. The strategy so far seems to be to create a largely diversified business conglomerate covering most business sectors of the economy. However, from the perspective of market concentration it is essential to follow closely the development of MIDROC-Ethiopia and how it uses its actual and potential market power.

Even though Sheik Mohammad Hussein Al-Amoudi's MIDROC-group's business activities are widespread and increasing, this group has not created a debate and a criticism that can compete with the debate about and the criticism of the other non-government business group, the EFFORT-group. As is clear from its name, this group has both its objective and its activities largely directed towards the Tigray region. Like the MIDROC-group, the EFFORT-group operates in more or less all business sectors.

According to information from EFFORT, this group was founded in August 1995 and its working capital is derived from resources endowed to the Foundation. EFFORT invests in several sectors of the Ethiopian economy (EFFORT 1997). Each of the Fund's companies "is an independent commercial entity registered under the commercial code of Ethiopia" (ibid.). Furthermore, "The activities of the Endowment Fund for the rehabilitation of Tigray complement government development programs" (ibid.).

The EFFORT-group has organised itself along the following business-sector lines:

- Agriculture and agro-processing
- Construction and engineering
- Manufacturing
- Mining
- Services, including banking (Wegagan) and transports (TESCO)

According to information obtained from interviews with private sector representatives, it seems so far to be mainly in the transport sector that the EFFORT-group has reached a dominant position. According to information from EFFORT, the Trans-Ethiopia Company's (TESCO) share of the Ethiopian freight market was 35 per cent in the fiscal year 1995/96.

It is obvious that the above-mentioned market position of TESCO, together with rules and procedures in the transport sector, easily lead to distortions and a feeling of discrimination among private individual truckers and trucking associations.

Considering the crucial role of the transport sector in Ethiopia, it is important to follow and analyse the situation in the transport market carefully and for the government to take necessary steps in the regulation and implementation of its transport policy so that efficiency is promoted and the risks of or actual abuses of distortionary market power are eliminated or reduced. The situation in the trucking industry should also be studied as an example of the problems that can arise as a result of the close links between the ruling government and party-owned private enterprises. Through such a critical study the risks of unfair competition and social losses due to inefficiency can be reduced or even eliminated.

As noted above, the EFFORT-group has its basis in the Tigray People's Liberation Front (TPLF) even though it is formally an independent share company. From the point of view of efficient competition, as indicated by the experience from the transport sector and revealed in the surveys about the business climate mentioned above, the close relation between TPLF and the present Ethiopian government easily creates doubts about the equal treatment of EFFORT-companies and other non-party-related private companies. As there is no efficient and working commercial legislation, these doubts, well founded or not, easily create problems concerning the government's legitimacy and the credibility of its private sector policies.

The doubts about the equal treatment of various non-government private actors within a sector, independently of the form of ownership and organisation, will most likely increase with the growth of party-related business. Therefore, it may turn out to be a severe problem that the Ethiopian government decided to allow the party to run businesses in October 1997.

There are at least two potential motives behind this change in policy. The change may be seen as a way to mobilise and utilise all available resources in the development process. However, it may also be seen as a way for the EPRDF to keep control over the more market-oriented and privatised economy, not only from the government offices but also as an active owner of business corporations.

Turning to the likely effects of the new policy, on the one hand, this change in policy can contribute to more regionally balanced economic activities than those that now characterize rural Ethiopia where non-peasant activities as a rule are in an infant stage. The exception today is Tigray, where the EFFORT-group clearly gives this region important non-agricultural resources. On the other hand, the increased involvement of the party in the business community easily creates negative effects in terms of reduced credibility and legitimacy of the government in the Ethiopian and international business community. There is an obvious risk that these negative effects will more than outweigh the short-run positive effects of mobilising and allocating party funds to the development of non-government economic activities.

A new proclamation on trade practices

In April 2003 the Ethiopian government presented a proclamation on trade practices (no 329/2003), which in Part Two presents a new anti-trust legislation. The new proclamation applies to all commercial activities except such activities that, according to the investment proclamation, are reserved for the Ethiopian Government. Furthermore “Enterprises having significant impact on development and designed by the Government to fasten growth and facilitate development” are also excluded and so are “Basic goods or services that are subject to price regulations” (Federal Negarit Gazeta No. 49, 17th April 2003, p 2153). At first sight these exceptions do not seem harmful. However, the exceptions that refer to enterprises that have significant impact on development as defined by the Government must be carefully and critically selected to avoid creating inefficiencies in the markets concerned. Examples of sectors where this exception limits the impact of the new legislation are the telecommunication and the banking sectors. However, it is important to note that the competition legislation of developed countries, Sweden for instance, also includes this type of exception (Carlsson K. et al. 1994: 16).

In addition to a general article on the prohibition of non-competitive behaviour, the proclamation defines a list of anti-competitive agreements that are illegal according to the new law. This list includes agreements on “jointly fixing prices”, “collusive tendering as to determine market price”, that segment markets or consumers, “allocation by quota of production and sales” and agreements on “refusal to deal, sell, and render services” (Federal Negarit Gazeta 2003: 2154). The contents of this list are quite appropriate considering the aim of the new legislation.

In anti-competitive legislation the phenomenon of “unfair competition” is central and must be clearly defined. According to the new Ethiopian Trade Practices Proclamation (Federal Negarit Gazeta 2003: 2154):

- 1) Any act or practice, in the course of commercial activities, that aims at eliminating competitors through different methods shall be deemed to be an act of unfair competition.
- 2) The following activities, in particular, shall be deemed to be acts of unfair competition.

- (a) Any act that causes, or is likely to cause, confusion with respect to another enterprise or its activities, in particular, the products or services offered by such enterprise;
- (b) Any act that damages, or is likely to damage the goodwill or reputation of another enterprise falsely;
- (c) Any act that misleads or is likely to mislead the public with respect to an enterprise or its activities, in particular, the products or services offered by such enterprise;
- (d) Any act of disclosure, acquisition or use of information without the consent of the rightful holder of that information in a manner contrary to honest commercial practice;
- (e) Any false or unjustifiable allegation that discredits or is likely to discredit with respect to another enterprise or its activities, in particular the products or services offered by such enterprise;
- (f) Any act that directly or indirectly restricts, impedes or weakens the competitive production and distribution of any commercial good or the rendering of any service;
- (g) Any act that restricts or debars the timely or economic means of producing or distributing any good or rendering of any service;
- (h) The importation of any goods from any foreign country into Ethiopia at a price less than the actual market price or wholesale prices of such goods in the principal markets of the country of their production with the intent to destroy or injure the production of such goods in Ethiopia or to restrict or monopolize any part of trade in such goods;
- (i) Trading in any manner in goods imported into Ethiopia for humanitarian purpose, without authorization by the Ministry; Federal Negarit Gazeta (2003: 2154f)

In the above definition of unfair competition activities the last one (i) does not make sense, given the objective of fair competition, provided that the conditions stated in (h) are satisfied. Of course free provision of food etc. that is imported into Ethiopia can undermine the market of efficient domestic or other foreign producers operating in the Ethiopian market. However, it is important to clearly define “humanitarian purpose” and how to allocate such goods to avoid misuse and thereby abuse of fair trade.

The concept of “market dominance” is crucial in competition legislation, and so it is in the case of the new Ethiopian trade practices proclamation, where it is explicitly stated that:

- 1) No person may carry on trade which gives opportunity to control a relevant market for goods or services; or limit access to a relevant market or otherwise unduly restrain competition, having or being likely to have adverse effects on market development.
- 2) The following practices shall in particular be deemed to be abuse of dominance.

- (a) The direct or indirect unfair imposition of excessively high or low selling price or service fee or withholding supply or any pre-emptive behaviour to impede entry into market
- (b) Acts which may be prejudicial to buyers of goods or services or which may hamper the growth of markets;
- (c) The selling of similar goods or services to consumers on unequal terms of payments;
- (d) The application to dealers in transaction of unequal terms in respect of similar goods, thereby placing some at competitive disadvantage;
- (e) To impose a condition of combined sales on a buyer when the goods or services so combined is not required by the buyer;
- (f) Issuance of any false or misleading commercial statement or notice, concerning goods and services in respect of their quality, quantity, volume, manufacturing process, component, strength, or the time and place of the production of goods or the rendering of services, or other similar conditions;
- (g) Hoarding, diverting or withholding goods from normal trade channels;
- (h) Refusing sales of goods or services to customers without good cause.
- (i) Selling at a price that does not cover production cost to eliminate fair competition.

Of these points no one can be classified as being in conflict with what is normally seen as abuse of market dominance. However, what is lacking is a definition of what should be classified as a “relevant market” and “market dominance” in the case of each and every type of goods or services. This is not easy, but the concept “market dominance” must be clearly defined so that the implementing “Investigation Commission”, that according to the new legislation should be established, can judge the relevance of complaints where reference is made to the trade practice proclamation.

Another point that must be added to the new legislation concerns mergers and acquisition of firms. This relates closely to the issue of market dominance and processes and must be defined to avoid the creation of high concentration and dominance in specific markets.

7 Conclusions and recommendations

The Ethiopian economy was severely hit by the drought in 2002/03 that reduced agricultural production by 12 per cent and made real GDP fall by 3.8 per cent. However, seen in a longer perspective, the economic performance in terms of fiscal balance and price stability has been satisfactory. The Ethiopian economy also suffers from the border conflict with Eritrea that is still not solved, even though there was a peace agreement in the year 2000. However, it still remains to implement the agreement and agree upon a border demarcation (July 2004). This has resulted in a deep diplomatic conflict that must be solved if conditions in the Horn are to have a chance to come close to the pre-1998 situation when the economic performance in Ethiopia and Eritrea was quite good.

The Ethiopian economic transition towards a market economy with increasing private ownership has been one of the major objectives since the beginning of the 1990s. The reform process has reached the level of implementation where to a large degree it has stopped. In interviews that the author conducted in October/November 2003 and March 2004, several individuals outside the government offices have claimed that this stop or slow progress is due to lack of government will – the government actions in terms of legislation and policy revision – are said to be just words to please the donors. Therefore, it is of crucial importance that the government intensifies its activities in various fields, mainly in institution building and in competence building.

This latter aspect cannot be overstated. Today private sector expansion is severely restricted and/or hampered by the lack of adequate competence in important fields like accounting, auditing, business and project evaluation, and commercial law. This is particularly important for small and medium-sized enterprises that want to borrow money for their investments and today the banks have problems in making proper credit evaluations. Finally, legal institutions for handling commercial relations and disputes must be updated or even created to reduce the uncertainties for potential businessmen in their investment decisions.

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Halving poverty by 2015 is one of the greatest challenges of our time, requiring cooperation and sustainability. The partner countries are responsible for their own development. Sida provides resources and develops knowledge and expertise, making the world a richer place.



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